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Minerals Management Service
Royalty Management Program
Building 85, Denver Federal Center
Denver, CO 80225

Attention: Mr. David S. Guzy - Chief, Rules and Publications Staff

Re: MMS Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases, 30 C.F.R. Part 206, 63 Fed. Reg. 6113 (February 6, 1998)

Dear Mr. Guzy:

Conoco Inc. ("Conoco") welcomes this opportunity to submit the enclosed comments to the Minerals Management Service ("MMS") with respect to the above-referenced Proposed Rule.

Conoco is a wholly-owned subsidiary of E. I. DuPont de Nemours and Company. In 1996 its worldwide production of crude oil, condensate, and natural gas liquids averaged 378,000 barrels per day and its worldwide natural gas production averaged 1,285 million cubic feet per day. During the five-year period ending December 31, 1996, Conoco remitted royalty payments to the MMS in excess of $393 million.

Conoco further adopts by reference and hereby incorporates the comments filed on behalf of the American Petroleum Institute and the Independent Petroleum Association of America, as well as the reports prepared by the Barents Group: "Analysis of the Department of Interior, Minerals Management Service's Request for Extension of the Existing Collection Authority for Form MMS-2014," dated March 6, 1998; "Analysis of the Department of Interior, Minerals Management Service's Form MMS-4415 under the Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases under the Paperwork Reduction Act," dated March 10, 1998; "Analysis of MMS' 'Economic Analysis of Proposed Federal Oil Valuation Rule Under Executive Order 12866'," dated April 7, 1998; and "Analysis of The Department of Interior, Minerals Management Service's Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases," dated April 7, 1998.

Thank you for the opportunity to comment on this matter. If you have any questions, please contact Mr. John Clark at (405) 767-5044.

Very truly yours,

GC Rule

George C. Rule

Enclosure

cc: John Clark, Ponca City
Carol Harvey, Houston

COMMENTS OF CONOCO INC.
REGARDING
DEPARTMENT OF INTERIOR
MINERALS MANAGEMENT SERVICE
SUPPLEMENTARY PROPOSED RULE
ESTABLISHING OIL VALUE FOR ROYALTY DUE ON FEDERAL LEASES
30 CFR PART 206

INTRODUCTION

On January 24, 1997, the Minerals Management Service (MMS) issued proposed new rules for Establishing Oil Value for Royalty Due on Federal Leases. These new rules were intended to replace rules that had been in effect since 1988. Since that time the MMS has spent over a year trying to determine how crude oil should be valued for royalty purposes due to the fact that their January 24, 1997 proposed rules were opposed by a significant number of lessees. The MMS has held "public hearings", "workshops" and three rounds of comments, which generated thousands of pages of comments, all of which appear to have been for naught. On February 6, 1998 the MMS issued its second "Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases" (Proposal). The MMS remains insistent on using a netback method (which it calls an index method, a term taken from gas regulations) for most oil producing areas in the United States even though such a method does not produce a fair or reasonable value for most lease oil production. Conoco Inc. (Conoco) is opposed to this method as the only mechanism available to lessees for valuing lease production.

I. FACTUAL/OPERATIONAL ISSUES

1. MMS Supplementary Proposed Rule Fails to Use Market Values at the Lease

On February 5, 1998, the MMS issued a press release wherein it stated that it "adhered to five basic principles of royalty valuation". The first principle on the list was:

> <u>Royalty must be based on the value of production at the lease.</u>
> The rule provides for royalty payments based on no more than the value of production at the lease. Where index prices are used to establish value, actual transportation costs, location differentials, and quality adjustments would be applied in arriving at the value at the lease.

The MMS's Proposal fails to recognize that trade center markets and lease markets are separate and distinct markets and are not influenced by the same market factors. Lease markets are affected by many factors that do not influence trade centers such as local refiner needs and their economic alternatives, competitors who are active in the lease market but who choose not to participate in trade center deals (and vice versa), and differences in available transportation outlets between buyers of lease production. Additionally, the refining industry does not have the same certainty of supply for lease crude acquisitions as they do for trade center purchases, so risks are different. A buyer at the lease takes the risk that a lease might experience a production outage which affects its availability to supply its downstream needs. However, trade center deals are for exact volumes that the refiner can count on. By ignoring these and many other differences between lease market and trade center markets the MMS is attempting to place the economic burden of these real differences on its lessees. This is neither fair nor reasonable.

In his prepared comments to the MMS on May 27, 1997 (directed at the original MMS Notice of Proposed Rule issued on January 24, 1997) Harvard professor Dr. Joseph P. Kalt, a leading petroleum economist, explained the economic differences between these two markets after examining hundreds of thousands of data points of actual arm's-length transactions and concluded that trade center markets are not appropriate measures of lease market values. Conoco strongly urges the MMS to once again read Dr. Kalt's comments and consider the economic rationale Dr. Kalt expressed differentiating these two markets.

Pursuant to the MMS request for input, Conoco, at the April 17, 1997 public hearing in Houston, Texas, offered an alternative to the netback (index) method for valuation of royalty oil at the lease level. Conoco proposed that the MMS consider including a "tendering" or "competitive bid" program as an election that lessees could choose from a menu of methods for royalty valuation. Conoco suggested this alternative for the following primary reasons:

a. The ***true*** value of lease production is **at the lease** and should be measured at the lease if at all possible. Conoco believes that the use of a netback (index) methodology should only be used as a last means of determining lease value, which is exactly the position the MMS took in their 1988 regulations.

b. Conoco agrees with the MMS that "one size does not fit all" but we disagree that this principle is only valid for the Rockies area. Thus, lessees need to have options (a menu) to choose from for lease valuation, not one single method for all situations.

c. Conoco believes that its competitive bid program is significantly less of an administrative burden to both the lessee and the MMS compared to the MMS proposed netback scheme. The MMS proposed rule will have essentially all producers of Federal oil filling out thousands of new MMS-4415 forms in an attempt to determine an MMS allowable deduction between MMS-defined aggregation points and trade centers. Conoco's previous comments have already explained that this will be a significant and costly burden to lessees. Conoco has about 1,000 contracts in effect at any one time and trying to keep up with the terms of these contracts for filling out MMS's newly proposed Form 4415 will require massive new systems and additional resources to keep up with the process of data collection and allocation, none of which adds any value to either Conoco or the MMS compared to Conoco's Competitive Bid Program. The stated purpose of these forms is to gather the "actual" differential between MMS-defined aggregation points and trade centers for lessees to use the following year as allowable deductions in computing MMS royalty payments. The MMS continues to ignore the fact that these differentials can change with each trade, and under its proposal lessees would be required to use old data that in all likelihood will not be reflective of current market conditions.

In contrast, Conoco's Competitive Bid Program has all these and most other market factors built into the bid process, making the collection of this massive amount of data unnecessary. Additionally, competitively bidding out oil for lease market value discovery purposes incorporates in the bids the effects of all the market factors that set a lease market apart from a trade center market. The bidders decide what value a barrel of crude has to them at the lease and make their bids accordingly. Massive data collection is not necessary. Competitive bidding is also responsive to contemporaneous market conditions. Year-old market differential data is not required to competitively bid out crude oil.

d. The MMS has focused on using "spot" information taken from Platt's Oilgram (Platt's) as being ***the value of crude oil.*** This has changed from the original proposed rule that referenced NYMEX prices as being ***the value of crude oil.*** The MMS has stated that they made the change because Platt's is supposed to be representative of actual trades and that Platt's reported prices and NYMEX figures, over time, are essentially the same. However, the MMS has failed to recognize that both Platt's and NYMEX reported market prices for crude oil represent a different market and should not be used for lease crude pricing. Platt's prices, as has been discussed before, are the result of daily telephone surveys by journalists. There is no evidence how many trades, if any, are transacted at these prices nor how many barrels were traded. When barrels do trade, in many instances they are purchased based on incremental economics, which represent the last few barrels a refiner will process, and normally exclude fixed costs in the economic analysis. Thus, trade center prices, for this and other reasons, may be inflated relative to actual lease market values. For a myriad of reasons, lease crude is generally marketed over a relatively long term basis while spot trade center production, almost by definition, is expected to be marketed over a very short term, sometimes just a few days and rarely more than a month.

e. Conoco offered a competitive bid alternative to the MMS, recognizing that this is the preferred method the Federal Government has used for years to sell government resources and property, such as oil from the Naval Petroleum Reserves, the Strategic Petroleum Reserves, standing timber in National Forests, government bonds, and so forth. Conoco cannot think of any justification for the MMS not to allow competitive bid programs to be a part of a menu of choices or even the preferred method for valuing lease crude oil.

Conoco's proposed alternative competitive bid program totally avoids or rectifies the problems with the MMS netback (index) method. When the MMS realized that an index method would not work for the Rockies they turned to a modified version of a competitive bid program (which is flawed as proposed) but rejected the same program for the rest of the United States. No reason was given other than its unsupported opinion that the index method is a good and reliable market indicator. MMS's refusal to recognize the actual market at the lease will no doubt result in lengthy, burdensome, costly and never-ending audits of lessees.

2. MMS Proposed Rockies Tendering Program is Flawed as Proposed

The MMS recognized that their netback scheme would not work for the Rocky Mountain Region. Even though Platt's reports a "spot" price for Wyoming Sweet crude at Guernsey, Wyoming, the MMS was convinced that this is not a reliable spot market for the Rockies. Therefore, its netback scheme becomes a real problem because there is no valid recognized starting point. In an attempt to rectify this problem, the MMS proposes that a tendering program be used. Under its flawed and restrictive tendering program, lessees will have to find three (3) qualified bidders before the program will qualify for valuing Federal royalty oil. No reason is given for setting the minimum number of bidders at three(3). Basic principles of competition are that "2 or more" parties meet the requirement for competition to exist. Under the MMS Proposal, to be a qualified bidder, the bidder cannot be offering production under a bid program of their own for oil production from the field or area. Conoco bids out oil in the Rockies and thus would likely not qualify as a bidder under the MMS program. Additionally, the MMS would mandate that 33 1/3% of the lessee's oil in that field or area must be sold under the bid program to make their program valid for MMS royalty valuation purposes. The 33 1/3% is unreasonable, arbitrary, and capricious. The MMS royalty interest in most onshore leases is 12½% and the government should not expect nor require that lessees offer and sell any more oil than the Federal royalty interest in an individual lease.

Answering a direct question from Conoco at the public hearing in Houston on February 18, 1998, the MMS stated that if the highest bid received came from a non-acceptable bidder (i.e., another company who also has a bid program), then that bid is not to be used for federal royalty valuation purposes. However, the MMS does not own all of the oil to be sold and the lessee would most likely not want to accept an inferior bid. Therefore, in this case, the lessee would probably sell the oil to the highest bidder even though that bidder is not acceptable to the MMS. The lessee, however, would be required to pay MMS royalty at the highest price from a "qualified bidder." Yet, under the regulations, the lessee is obligated to pay the MMS no less than "gross proceeds." Hence, there is a serious contradiction in the supplementary proposed rule.

II. LEGAL ISSUES

1. The Proposal's provisions for valuation of arm's-length contracts exclude many bona-fide arm's-length contracts.

§206.100 defines "affiliate" to include "a person who owns, is owned by, or is under common ownership with another person to the extent of 10 percent or more of the voting securities of any entity, interest in a partnership or joint venture, or other forms of ownership." With no explanation whatsoever, the Proposal would abandon the compromise reached in the 1988 regulations. Based on BLM coal leasing regulations, which remain unchanged, the 1988 regulations avoid the simplistically low 10 percent threshold of the present Proposal in favor of a sensible, fair, three-level control approach:

- (I) Ownership in excess of 50 percent constitutes control;
- (ii) Ownership of 20 through 50 percent creates a presumption of control; and
- (iii) Ownership of less than 20 percent creates a presumption of noncontrol.

2. The Proposal's provisions for valuation of non-arm's-length contracts are arbitrary and capricious.

In comments submitted earlier in the rulemaking, industry emphasized that geographically non-uniform valuation regulations imposed a special hardship on companies which produce oil and gas in several geographic regions. If the valuation regulations vary appreciably from region to region, the administrative systems needed to support them must differ appreciably as well. Nonetheless, the Proposal continues to reflect the MMS's view that non uniform regulations are appropriate.

§206.103(b) Rocky Mountain Area

The Proposal at §206.103(b)(1) would permit use of a tendering program which suffers from the many shortcomings described above. As a practical matter, the MMS's Proposal all but eliminates the tendering program as a meaningful option, even for the Rocky Mountain Region.

Second, and more fundamental, the MMS offers no rationale for limiting use of a tendering program to the Rocky Mountain Region. At the MMS's Fall 1997 workshops, there was a broad base of support for the use of a properly designed tendering program as an alternative to indexing generally, yet the MMS Proposal simply ignores that. Also, many questions remain unanswered. What criteria would be used by the MMS for review of a tendering program under (b)(1) to implement the 33 1/3% and three bidders requirements? What time period does the MMS have in mind? Can a payor slip in and out of eligibility? When will additional criteria appear in the MMS "Oil and Gas Payor Handbook"? When would the MMS approve a tendering program? How would a payor know with certainty whether a potential bidder has what the MMS considers to be an acceptable tendering program?

Third, the NYMEX netback methodology is arbitrary and capricious - among other deficiencies, it would require valuing Wyoming sour crude using a NYMEX sweet price.

§206.103(c) Areas Other Than Alaska, California and Rocky Mountain Region

The Proposal's treatment of most geographic regions of the nation and the vast bulk of its production is replete with fundamental problems. Although the Proposal would use spot prices in lieu of the original Proposal's use of NYMEX prices, the Proposal offers no response to the focused criticism of crude oil spot prices as a measure of value for royalty purposes. As earlier Conoco comments have stated, spot prices for crude oil (unlike spot prices for gas) are an altogether inappropriate measure of the value of production and the MMS should abandon their use for valuation purposes.

3. **The Proposal unlawfully requires that production be marketed at no cost to the lessor.**

As proposed, §206.106 states:

> "You must place oil in marketable condition and market the oil for the mutual benefit of the lessee and the lessor at no cost to the federal government unless otherwise provided in the lease agreement..."

Here again, the Proposal reflects no change whatsoever from the MMS's original January 1997 Proposal. The imposition of the duty to market free of charge is not a mere clarification of existing requirements but a radical change. Under applicable mineral leasing statutes royalty is due on the "value of production," not on an enhanced value downstream.

4. **The Proposal unlawfully moves the point of valuation downstream of the lease.**

Independent of the Proposal's attempt to unlawfully impose on the lessee a duty to market free of charge, the Proposal contains several other provisions which, like the use of spot prices, effectively move the valuation point downstream, away from the lease and point of production.

First, even where §206.102 is applicable, it would in many cases be available only after one or more resales have occurred. As a result, §206.101(a)(3) would permit the use of gross proceeds only after the crude oil is "ultimately sold" under an arm's-length contract. This assumes that crude oil can be traced from the lease to the refinery gate which is a virtual impossibility. It also plainly violates the statutory requirement that royalty be based on the "value of production" at or near the lease.

Second, where no arm's-length contract (by the MMS definition) exists, §206.103 requires, except for some limited cases in the Rocky Mountain Region, the use of spot prices or NYMEX index prices together with location/quality differentials. This methodology unlawfully captures increments of value added as the crude oil moves downstream away from the lease.

Under §206.107, the availability of non-binding guidance does not square with the Proposal's professed objective of certainty. Would interest and penalties apply where the payor relies on an MMS "non-binding determination"?

5. Many aspects of the proposal are either unworkable or unduly costly.

For the reasons described above, §206.102 is unduly limited to a small fraction of bona-fide arm's-length transactions. Moreover, §206.102 is wholly unworkable and cannot be done because of its explicit tracing requirements. These requirements are not only burdensome but presume a high degree of accuracy in tracking volumes which, in practice, cannot be done. Where multiple contracts are involved, there is the additional complication of commingling, perhaps even federal and non-federal production.

6. The Proposal does not bring certainty to the royalty process.

In many places, key determinations will be made after the fact, such as in the area of differentials. The Proposal also assumes a static marketplace based solely on the existence of spot prices. Furthermore, the Proposal is simply too complex.

CONCLUSION

For the reasons stated above, it is imperative that MMS rethink its proposed rule.